SUPREME COURT, U. S.

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Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1733

GEORGE T. and RUTH A. KIMBELL,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

HAROLD D. ROGERS
1100 Hamilton Building
Wichita Falls, Texas 76301
Counsel for Petitioners

Of Counsel:
SHERRILL, PACE & ROGERS
1100 Hamilton Building
Wichita Falls, Texas 76301

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, 421-3030

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The petitioners pray that a writ of certiorari issue to review the judgment of the Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals, as yet unreported, appears at Appendix A, at page A1. The opinion of the District Court for the Northern District of Texas, 364 Fed. Supp. 1232, appears at Appendix B, at page A8.

JURISDICTION

The judgment of the Court below was entered on February 22, 1974. This petition for certiorari was filed less than 90 days from the date aforesaid. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the payment of $49,500 by petitioner in 1967 to Dart Oil & Gas, Inc. was an ordinary and necessary business expense or a capital loss.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * *

SEC. 1211. LIMITATION ON CAPITAL LOSSES.

(b) *Other Taxpayers.*—In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller. For purposes of this subsection, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. If the taxpayer elects to pay the optional tax imposed by section 3, "taxable income" as used in this subsection shall be read as "adjusted gross income".

STATEMENT OF THE CASE

This Petition for a Writ of Certiorari by petitioners, George T. and Ruth A. Kimbell, is from a judgment of the Fifth Circuit affirming a judgment of the United States District Court for the Northern District of Texas denying

to petitioners a refund of federal income taxes paid pursuant to an assessment by the Commissioner of Internal Revenue.

Jurisdiction for the filing of the suit in the United States District Court was based upon 28 U.S.C. 1346.

Petitioners are residents of Wichita Falls, Texas. Petitioner George T. Kimbell ("Petitioner") has been engaged in the oil and gas business since 1928. During the year 1967 petitioner owned approximately 65 producing oil and gas leases.

On March 8, 1961, petitioners sold to Elba Corporation ("Elba") all of their undivided interests in two oil and gas leases (called "Castleberry Leases") located in Gregg County, Texas. Petitioners reported a Section 1231 gain of $216,861.22 in 1961 from the sale of the Castleberry Leases. There were several other owners of undivided interests in the Castleberry Leases, all of whom joined in the sale to Elba. Unknown to petitioner, Elba had borrowed funds from Texas Bank & Trust Company of Dallas ("Texas Bank") to finance its purchase of the Castleberry Leases. At the closing of the sale in John Stigall's ("Stigall") law office on March 8, 1961, Stigall made no representation that he represented the Texas Bank. Petitioner assumed that Stigall was representing Elba at the closing of the sale in Stigall's office since he did not know Stigall and no representation was made to him as to any other purchasers besides Elba.

In 1962 Texas Bank, through its attorney, John B. Stigall, orally asserted a claim against petitioner and others (called "Kimbell *et al.*") alleging that Kimbell *et al.* were liable in tort for defrauding the Texas Bank in the sale of the Castleberry Leases to Elba, since they knew or should have known that the bank was funding the sale, and they knew that the wells were illegally produced.

The Texas Bank further alleged that it had been damaged in the amount of $1,000,000. This claim was based upon the fact that petitioner attended the closing in Stigall's office and that petitioner should have told the Texas Bank that the wells were deviated knowing that the Bank was advancing the money. Petitioner not only did not know the Bank was advancing the funds, but did not know the wells were deviated, since he was a non-operator of the Leases. The Texas Bank did not assert a claim against any of the other owners of the other undivided interests in the Castleberry Leases. Petitioner denied all of such allegations made by the Texas Bank. Subsequently, petitioner and his son, D. A. Kimbell, agreed to settle the threatened lawsuit. On March 30, 1967, petitioner and D. A. Kimbell paid $112,500 to Dart Oil & Gas, Inc. ("Dart") for a release of all claims asserted against them by Texas Bank. Of the total of $112,500, petitioner paid $49,500. Dart was incorporated sometime after September, 1962.

The $49,500 paid by petitioner to Dart was applied upon an indebtedness of Dart to Texas Bank, which indebtedness was incurred by Dart in drilling wells on the Castleberry Leases after petitioner's sale to Elba. Dart was a wholly owned subsidiary of Claubet Corporation. Claubet was owned 100% by Stigall.

Petitioner had built, over a period of many years, an excellent business reputation in the oil and gas business community in Texas, Louisiana, Oklahoma and throughout the Southwest. Petitioner, individually, and through related entities, was active in the acquisition of oil and gas properties. A lawsuit filed against petitioner alleging fraud or misrepresentation by Texas Bank would have severely damaged petitioner's business reputation throughout the oil and gas industry. In all of his years as an independent oil operator, petitioner had never been sued

for fraud, misrepresentation or for any other wrongdoing of any kind.

Petitioner agreed to settle the threatened lawsuit on the advice of his counsel that such settlement would (1) protect his business reputation since a lawsuit would result in unfavorable publicity, (2) save large attorney fees and court costs and (3) prevent the possibility of lawsuits by adjoining lease owners for drainage. Although the petitioner's attorney, Angus Wynne, advised taxpayer the case could be won, he was especially concerned that a lawsuit alleging deviated wells on the Castleberry Leases would be very detrimental to taxpayer's business reputation since other lawsuits involving slant holes in East Texas had produced a great deal of notoriety and unsavory remarks about such defendants.

Dart and Texas Bank were strangers to the sale of the Castleberry Leases since petitioner had no knowledge in 1961 that the Texas Bank was funding the sales price to Elba, and Dart did not come into existence until sometime after the closing of the sale to Elba in 1961. Further, under Texas law, petitioner had no liability to Texas Bank or Dart since any duty owed by him was owed to Elba and not to any third party.

On their 1967 joint income tax return, petitioners deducted the said $49,500 as an ordinary business expense, and the Internal Revenue Service, upon audit, determined that such expense was a long term capital loss. Thereafter, petitioners filed a claim for refund alleging that such payment was deductible as an ordinary and necessary business expense. The Internal Revenue Service denied such claim and petitioners filed the instant suit for refund of income taxes in the United States District Court for the Northern District of Texas.

REASONS FOR GRANTING THE WRIT

The decision below will be in direct conflict with the case of Commissioner v. Cummings (on appeal to the Second Circuit) if said case is affirmed by the Second Circuit.

In the case of *Nathan Cummings*, 60 T.C. 91 (1973) the Tax Court held that a payment made to protect a taxpayer's business reputation and to avoid unfavorable publicity was fully deductible as a business expense and not as a capital loss. The *Cummings* case is on appeal to the Second Circuit (No. T-3065, January 8, 1974).

The issue in the instant case is identical to the issue in the *Cummings* case. In the instant case and the *Cummings* case, the issue was whether a payment made to protect one's business reputation is deductible as a business expense or as a capital loss. Thus, if the *Cummings* case is affirmed by the Second Circuit, then a direct conflict would exist between the Fifth and Second Circuits resulting in the necessity for this Court to resolve such conflict.

In both the instant case and in the *Cummings* case, there was a prior capital transaction which was reported by each taxpayer as capital gain. In the *Cummings* case the Tax Court held that the prior capital transaction did not require Cummings to report as a capital loss his subsequent payment to protect his business reputation. In the instant case the Fifth Circuit held that such prior capital transaction required the subsequent payment to be reported as a capital loss even though the subsequent $49,500 payment was made solely to protect petitioner's business reputation. The *Cummings* case will be in direct conflict if affirmed by the Second Circuit since such holding would authorize the subsequent payment to be deducted as a business expense notwithstanding the prior capital gain transaction.

If the Second Circuit affirms the *Cummings* case, then the United States would certainly file a petition for writ of certiorari to this Court since that case would be in direct conflict with the Fifth Circuit's judgment in the instant case.

The only way petitioners can protect their position pending the decision of the Second Circuit in *Cummings* is to file this Petition for Writ of Certiorari. If the *Cummings* case is reversed by the Second Circuit, then petitioners will agree to dismiss the petition filed herein.

CONCLUSION

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted if the Second Circuit affirms the Tax Court in *Commissioner* v. *Cummings, supra.*

Respectfully submitted,

HAROLD D. ROGERS
1100 Hamilton Building
Wichita Falls, Texas 76301
Counsel for Petitioners

Of Counsel:
SHERRILL, PACE & ROGERS
1100 Hamilton Building
Wichita Falls, Texas 76301

APPENDIX

APPENDIX A

George T. and Ruth A. KIMBELL, Plaintiffs-Appellants,

v.

UNITED STATES of America, Defendant-Appellee.

No. 73-3411

Summary Calendar.*

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.

Feb. 22, 1974.

Tax refund suit. The United States District Court for the Northern District of Texas at Wichita Falls, Robert M. Hill, J., 364 F.Supp. 1232, upheld the determination of the Commissioner of Internal Revenue that $49,500 expended by the taxpayer was a capital loss and not a fully deductible business expense. The taxpayer appealed. The Court of Appeals, Roney, Circuit Judge, held that payment made by a taxpayer in satisfaction of a liability arising from an earlier transaction on which the taxpayer has reported capital gain must be treated as a capital loss at least to the amount of the capital gain, regardless of the taxpayer's motivation for making the payment.

Affirmed.

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*Rule 18, 5th Cir.; see Isbell Enterprises, Inc. v. Citizens Casualty Co. of New York et al., 5th Cir. 1970, 431 F.2d 409, Part I.

1. Internal Revenue (Key) 566.1, 612.7

Where income taxpayer sold his interest in oil and gas leases and reported long-term capital gain of $190,000, his subsequent payment of $49,500 to settle fraud claim of holder of security interest from buyer of the leases was to be treated as capital loss, and not fully deductible business expense, though taxpayer argued that claim was settled to protect business reputation, to save large attorney's fees and court costs and to prevent possibility of lawsuits by adjoining lease owners for drainage.

2. Internal Revenue (Key) 566.1, 612.7

It is origin and character of claim against taxpayer that controls characterization of settlement expenses for federal income tax purposes.

3. Internal Revenue (Key) 566.1, 612.7

Payment made by income taxpayer in satisfaction of liability arising from earlier transaction on which taxpayer reported capital gain must be treated as capital loss at least to amount of the capital gain, and not as fully deductible business expense, regardless of taxpayer's motivation for making the payment.

Appeal from the United States District Court for the Northern District of Texas.

Before COLEMAN, DYER and RONEY, Circuit Judges.

RONEY, Circuit Judge:

In this tax refund suit, the District Court upheld the determination of the Commissioner of Internal Revenue

that $49,500 expended by the taxpayer was a capital loss and not a fully deductible business expense. We affirm.

In 1961, taxpayer sold his interest in two oil and gas leases and reported a long-term capital gain of $190,000 from the sale. In 1962, it was discovered that the wells on the two leases were illegally slanted and production was halted. A bank which had obtained a security interest in the leases from the buyer at the time of purchase then threatened a lawsuit against taxpayer. Taxpayer settled the claim based on fraud for $49,500 in 1967 and deducted the payment as an ordinary and necessary business expense. The Commissioner allowed the deduction only as a capital loss.

Taxpayer testified that he and his attorney were convinced that the bank's claim was entirely without merit but that nonetheless he agreed to settle because a lawsuit alleging illegal slant wells would have had a detrimental effect on his business reputation in the oil and gas industry. Taxpayer argues that the claim was settled to (1) protect taxpayer's business reputation since a lawsuit would result in unfavorable publicity, (2) save large attorney's fees and court costs, and (3) prevent the possibility of lawsuits by adjoining lease owners for drainage.

Taxpayer argues that this undisputed evidence requires a finding that the payments were made to protect a taxpayer's business or to avoid unfavorable commercial publicity and thus are ordinary business expenses under Helvering v. Community Bond & Mortgage Corp., 74 F.2d 727 (2d Cir. 1935); Paul Draper, 26 T.C. 201 (1956), and William L. Butler, 17 T.C. 675 (1951). In none of those cases, however, was the payment connected with a prior capital transaction from which a taxpayer derived the benefit of lower tax rates on capital gains.

[1] We agree with the District Court that the principle in Arrowsmith v. Commissioner of Internal Revenue, 344 U.S. 6, 73 S.Ct. 71, 97 L.Ed. 6 (1952) is controlling. In *Arrowsmith*, two taxpayers liquidated their jointly owned corporation, reporting their profit on the transaction as capital gain. Subsequently, they, as transferees of the corporate assets, were required to pay a judgment rendered against the corporation. They sought to deduct the payments as business expenses. The Supreme Court held the payments to be a part of the original liquidation transaction, requiring classification as capital losses.

The taxpayer argues that *Arrowsmith* is distinguishable because the payments there were made against a legal liability existing prior to final liquidation and the *Arrowsmith* taxpayers did not make the payments to protect their business reputations.

[2] There is no indication in *Arrowsmith*, however, that the claim's existence prior to liquidation was in any way controlling. The basic character of the transaction giving rise to the settlement payment would be the same whenever the legal claim was asserted. Taxpayer's subjective motivation for making a settlement payment is irrelevant to the determination of its deductibility. It is the origin and character of the claim against the taxpayer that controls the characterization of settlement expenses for federal tax purposes. Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908, 91 S.Ct. 866, 27 L.Ed.2d 806 (1971); *see* United States v. Hilton Hotels Corp., 397 U.S. 580, 90 S.Ct. 1307, 25 L.Ed.2d 585 (1970); Woodward v. Commissioner of Internal Revenue, 397 U.S. 572, 90 S.Ct. 1302, 25 L.Ed.2d 577 (1970); United States v. Patrick, 372 U.S. 53, 83 S.Ct. 618, 9 L.Ed.2d 580 (1963); United States v. Gilmore, 372 U.S. 39, 83 S.Ct. 623, 9 L.Ed.2d 570 (1963).

Explaining the rationale in *Arrowsmith*, the Supreme Court later said "if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income." United States v. Skelly Oil Co., 394 U.S. 678, 685, 89 S.Ct. 1379, 1383, 22 L.Ed.2d 642 (1969).

Taxpayer relies on five Tax Court opinions to establish the principle that a payment made to protect a taxpayer's business reputation and avoid unfavorable publicity is deductible as an ordinary and necessary business expense. Charles I. Brown, T.C. Memo 1973-275 (Dec. 17, 1973); Nathan Cummings, 60 T.C. 91 (1973), appeal docketed, No. T-3065, 2d Cir., Jan. 8, 1974; James E. Anderson, 56 T.C. 1370 (1971), rev'd, 480 F.2d 1304 (7th Cir. 1973); William L. Mitchell, 52 T.C. 170 (1969), rev'd, 428 F.2d 259 (6th Cir. 1970), cert. denied, 401 U.S. 909, 91 S.Ct. 868, 27 L.Ed.2d 807 (1971); Laurence M. Marks, 27 T.C. 464 (1956). Those cases involved the deductibility of corporate insiders' payments to their corporations of profits from short swing transactions in company stock, pursuant to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78p(b). The Tax Court held that the insiders' obligation to make the payments derived from their status as insider employees covered by section 16(b) and not from the stock transactions. That Court noted that the short swing profits for which an insider is accountable—the difference between the sale proceeds and the cost of purchasing replacement stock—is unrelated to the amount of capital gain realized—the excess of the sale proceeds over the cost of the stock sold. Thus, the Tax Court distinguished *Arrowsmith* and *Skelly Oil* on the ground that a section 16(b) payment is not directly and integrally related to the earlier capital-gains-producing sale.

Both the Sixth and Seventh Circuits have rejected the Tax Court's position. Anderson v. Commissioner of Internal Revenue, 480 F.2d 1304 (7th Cir. 1973); Mitchell v. Commissioner of Internal Revenue, 428 F.2d 259 (6th Cir. 1970), cert. denied, 401 U.S. 909, 91 S.Ct. 868, 27 L.Ed.2d 807 (1971). They applied the *Arrowsmith* principle on the ground that the liability of the taxpayers was predicated on sales resulting in capital gains. These Circuits characterized a section 16(b) payment to a corporation as representing a portion of the stock's sales price and as an adjustment on that price, which would ordinarily reduce the amount of capital gain. Despite the *Mitchell* and *Anderson* reversals, the Tax Court, in *Cummings* (now on appeal in the Second Circuit) and *Brown*, has expressly declined to adopt a different standard for determining the character of the deduction claimed in those cases. Comment on the merits of this dispute between the Courts of Appeal and the Tax Court is neither appropriate nor necessary to the resolution of this appeal.

Assuming *arguendo* the validity of the Tax Court position, the fair implication of that Court's opinion supports the application of the *Arrowsmith* principle to this case. The Tax Court recognizes that even a narrow interpretation of the Supreme Court's ruling would control a "situation where the taxpayer, having received money *in one capacity*, was required *in that same capacity* to *repay* that money to the same person who made the payment." James E. Anderson, *supra*, 56 T.C. at 1376. Here the taxpayer obtained the proceeds of the sale of his oil leases in his capacity as their seller. The claim that he deemed expedient to settle was asserted against him because he was the seller. The settlement payment was delivered to the nominee of the bank which had succeeded to the interest of the purchaser. Thus, taxpayer fails even under a narrow interpretation of *Arrowsmith*.

[3] In short, we hold that a payment made by a taxpayer in satisfaction of a liability arising from an earlier transaction, on which that taxpayer reported capital gain, must be treated as a capital loss at least to the amount of the capital gain, regardless of the taxpayer's motivation for making the payment.

Affirmed.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF TEXAS
WICHITA FALLS DIVISION

Civil Action No. CA-7-656

GEORGE T. AND RUTH A. KIMBELL,
Plaintiffs

v.

UNITED STATES OF AMERICA,
Defendant

MEMORANDUM OPINION

(Filed August 17, 1973)

George T. Kimbell and Ruth A. Kimbell, plaintiffs, have brought this suit against the United States of America pursuant to 28 U.S.C. §1346(a). Plaintiffs, who are husband and wife, seek a refund of income taxes alleged to have been improperly assessed and collected for their taxable year 1967. The sole issue presented by this suit is whether a payment in settlement of a threatened lawsuit is deductible as an ordinary business expense or as a capital loss.

George Kimbell, the principal taxpayer, has been engaged continuously since 1928 in the business of producing and selling oil and gas. Kimbell testified that he was not in the business of buying and then selling oil and gas leases but was only in the business of acquiring the working interest in leases for development of oil and gas. Plaintiffs acquired part of the working interest in two oil and gas leases in Gregg County, Texas. On March 8, 1961, The Elba Corporation bought these two leases,

paying a consideration of approximately $840,000. For their interest in these leases plaintiffs received the sum of $216,861 and reported a long-term capital gain of $193,532 to the Internal Revenue Service (IRS) on this transaction. At the time of this sale there was oil production from these leases. Elba Corporation and its owner, W. O. Davis, financed the purchase of these leases by obtaining a loan from the Texas Bank and Trust Company of Dallas, Texas. As collateral for the loan the bank obtained a security interest in the oil production from these leases.

In 1962, it was discovered that the wells on these two leases were illegally slanted and production was halted. The Elba Corporation and Davis then defaulted on their loan with the bank. The bank immediately asserted a claim and threatened a lawsuit against plaintiffs in the amount of $1,000,000 on the theory that plaintiffs knew that the wells on these two leases were producing illegally when the leases were sold and that plaintiffs also knew that the bank was financing the purchase of the leases. There then began a series of negotiations between the plaintiffs and the bank which culminated on March 30, 1967 when plaintiffs paid $49,500 to the bank in settlement of all claims then being asserted. Kimbell has at all times denied the validity of the bank's charges.

Kimbell testified that he agreed to settle the threatened lawsuit by the bank because a lawsuit, even though it be without basis, charging him with fraud would have an adverse effect on his reputation and operations in the oil and gas business. In addition, he testified that the settlement resulted in a saving of substantial attorneys fees and court costs which would have been incurred in defending the bank's lawsuit.

On their 1967 joint income tax return plaintiffs deducted the $49,500 payment as an ordinary business expense. Upon audit, the IRS made a determination that the payment was a capital loss and that only fifty percent of that payment was properly deductible. It is from this determination that the present litigation arises.

The fact that a taxpayer pays out money in settlement of a threatened lawsuit does not always create a business expense deduction. Before such a deduction can be allowed, it must constitute an expense of carrying on the taxpayer's business. In *Anchor Coupling Co.* v. *United States*, 427 F.2d 429 (7th Cir. 1970), a taxpayer corporation settled a threatened lawsuit with a payment of $600,000 in order to avoid the adverse effects of the alleged claim upon its business. The district court, relying on the taxpayer's motive, held that the payment was an ordinary business expense. The Court of Appeals reversed the district court, holding that a deductible business expense for settlement of a threatened lawsuit cannot hinge on the taxpayer's motive. Such "elusive" considerations would only "encourage schemes of tax avoidance." 427 F.2d at 433. The court then concluded that the origin of a threatened lawsuit, rather than its consequences on the business reputation of a taxpayer, is the controlling test of whether a settlement payment constitutes a deductible business expense. *Id.* The motive or purpose of a taxpayer does not govern the deductibility of a payment paid in settlement of a threatened lawsuit, rather the more objective test which is premised on the nature of the claim giving rise to the threatened liability. *United States* v. *Gilmore*, 372 U.S. 39 (1962).

It is undisputed that the bank's claim arose from the plaintiffs' sale of the Gregg County oil and gas leases and the bank sought a recoupment of the purchase price

paid to the plaintiffs. The nature of the transaction which gave rise to the plaintiffs alleged liability was an exchange of capital assets. As a result of this exchange the plaintiff reported $193,532 as a long-term capital gain. *Arrowsmith* v. *Commissioner,* 344 U.S. 6 (1952), is clearly applicable to the circumstances in the instant cause.

In *Arrowsmith,* two taxpayers received payments for the liquidation of their corporations. Four years after they reported these payments as capital gains, a judgment was rendered against the corporation. Each of the taxpayers paid half the judgment and deducted 100% of that amount as an ordinary business loss. The Supreme Court held the losses to be capital losses since the taxpayer's liability was not based on any ordinary business transaction apart from the sale of a capital asset. The court then concluded that where a taxpayer receives and reports a capital gain, a subsequent payment made by that taxpayer in satisfaction of a liability arising from the earlier capital transaction must be treated as a capital loss. 344 U.S. at 8. The reason for this rule is that the tax laws will not be interpreted to allow a taxpayer the equivalent of a double deduction. *United States* v. *Skelly Oil Co.,* 394 U.S. 678 (1969); *Mitchell* v. *Commissioner,* 428 F.2d 259 (6th Cir. 1970).

For this court to treat the payment made by plaintiffs in settlement of the bank's threatened lawsuit as an ordinary business expense[1] would clearly give the plaintiffs the equivalent of a double deduction. This court is of the opinion that the payment made by plaintiffs was in effect a repayment of capital gains from the sale of oil and gas leases, and accordingly the payment should be

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1. Additionally, the plaintiffs have failed to show that the payment was an "ordinary expense" common to the production of oil and gas, which is the plaintiffs' business.

treated as a capital loss rather than a deductible business expense.

The above will serve as this court's finding of facts and conclusions of law and counsel for the government will prepare an appropriate order for entry by the court.

Dated this 16th day of August, 1973.

/s/ Robert M. Hill
United States District Judge